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Financial Market Review, Fourth Quarter 2007

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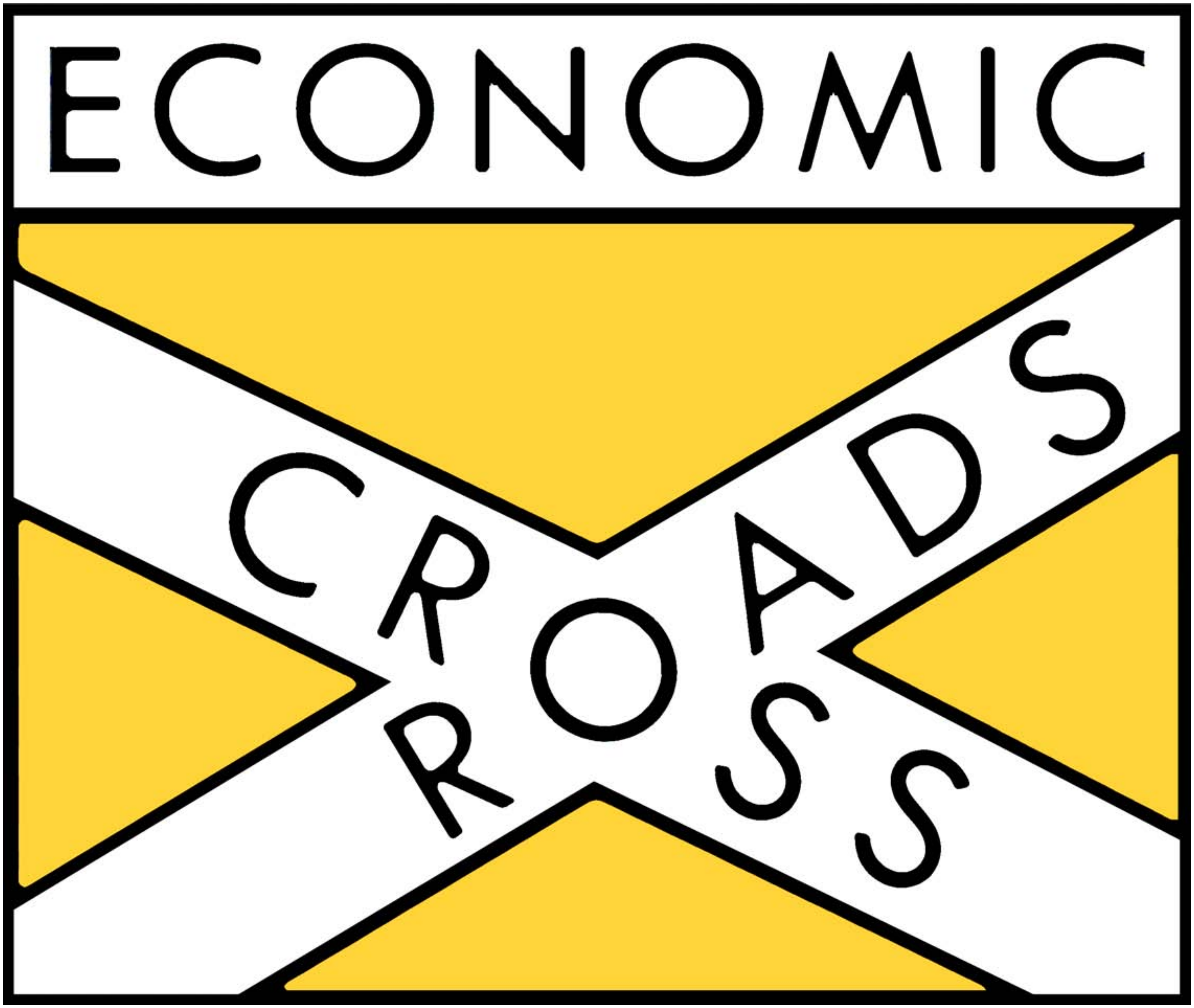

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Optimism was rampant during the first half of 2007 as major equity market indices reached new highs and nothing but blue skies appeared on the horizon. However, the outlook became cloudy in May when problems in sub-prime mortgages began to surface. By the summer, a full fledged credit crunch emerged as continued weakness in the housing market and troubles with mortgage-backed securities spilled over into the broader credit markets. As investors began to worry about a possible recession, US equities finished well off their highs. For the year, the market registered below-average 12-month returns but did so with volatility that was the highest in several years.

EQUITY MARKET

Major US stock indices were off 2-5% for the fourth quarter, their first decline in the fourth quarter in at least seven years. For the year, the broad market (DJ Wilshire 5000 Index) was up 5.7%, but this masked a huge differential between large and small cap stocks. Large caps (S&P 500) enjoyed a 12-month total return of 5.5% and mid caps did even better at 8.0%. In times of economic uncertainty, investors generally favor the greater earnings stability of larger companies and these companies are also generally benefiting more from the stronger growth being experienced by foreign economies. In a decisive reversal of small caps' decade-long outperformance, these fundamental factors contributed to the Russell 2000 registering a 1.6% decline for the year.

Reflecting strong growth as well as many successful new product introductions and innovations, technology staged a successful comeback in 2007 as the NASDAQ Composite rose 9.8%, this market's best return since 2003.

In another decisive reversal of a longstanding trend, growth handily outperformed value both for the fourth quarter and year-to-date. According to the Russell indices, the 12-month differential was 12% in large caps and nearly 17% in small caps. Most of the year's worst performing sectors were in the value tent.

The year's best performing sectors included utilities and consumer staples— sectors that would be expected to hold up well during a period of economic slowdown. The lagging sectors included some that are most vulnerable to economic weakness in general and housing problems in particular, such as financials and consumer-related sectors including retail. Among the S&P 500's major sectors, energy and materials were up 32% and 20%, respectively, while financials and consumer discretionary lost 21% and 14%, respectively.

Reflecting the sharp disparity in industrial sector returns, there were unusually wide differentials in the performance of individual stocks. Among the Dow Industrial stocks, Merck, McDonalds, Honeywell, and Intel all enjoyed yearly gains in excess of 30%, while AIG (-18.6%), Home Depot (-32.9%), and Citigroup (-47.1%) were big disappointments. Among other stocks, Google (+50.2%), Amazon.com (+134.8%), and Apple (+133.5%) had stellar years while Merrill Lynch (-42.3%), E-Trade (-84.2%), Countrywide Financial (-78.9%), and MBIA (-74.5%) suffered major declines that were impacted by subprime mortgage investments. The CEOs of Citigroup and Merrill Lynch were two of the most notable casualties of the enfolding meltdown in mortgage-related securities.

For the fifth consecutive year, world stock markets outperformed the US but performance was far from uniform. Many European markets were hampered by spillover effects of the US credit crunch and troubled subprime mortgages. Only Germany, buoyed by strong

Chart 1

S&P 500, 2007: Ups and Downs, But Modestly Up

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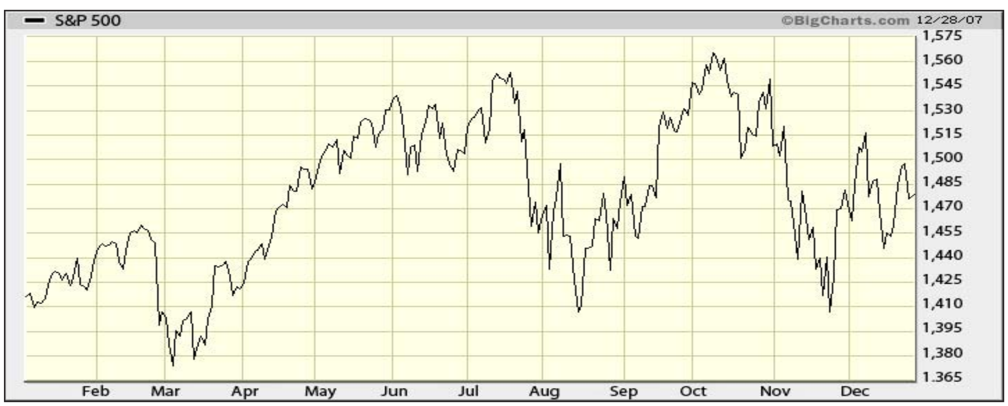

Chart 2

S&P 500, 2003-2007: A Five-year Bull Market

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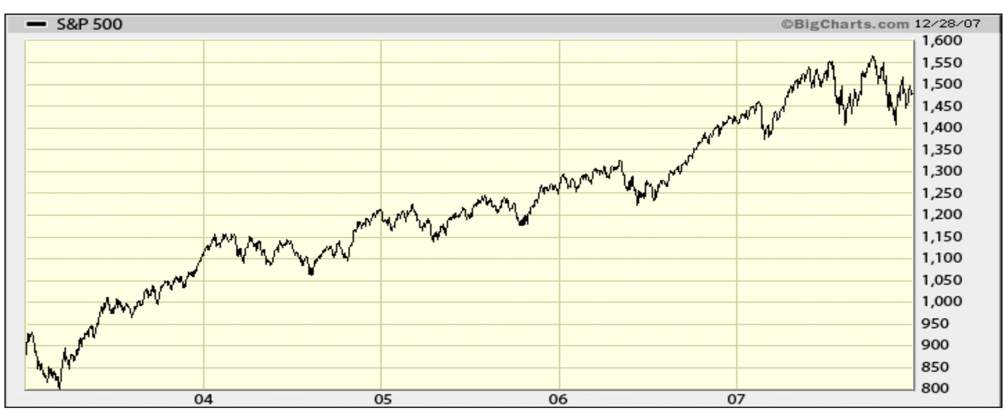

Chart 3

S&P 500, Ten Years: Before Setback, a New High Reached

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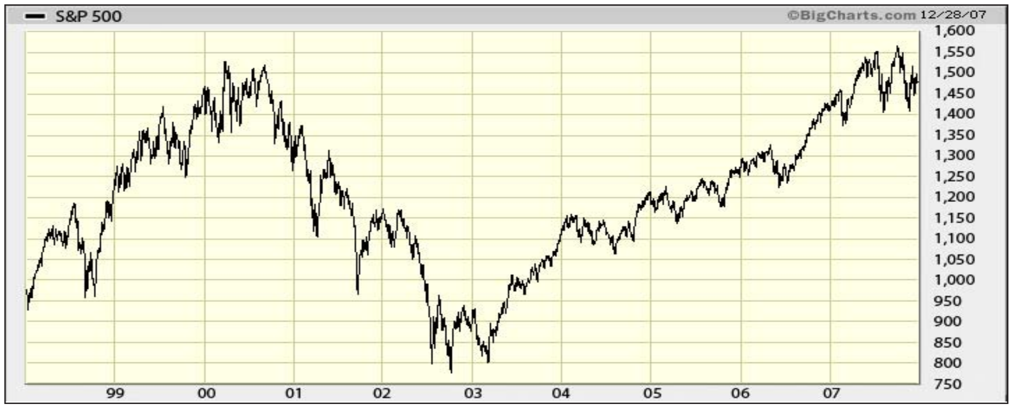

Chart 4

S&P 500 vs. Russell 2000, Five Years: Even After 2007 Setback, Small Caps Rule

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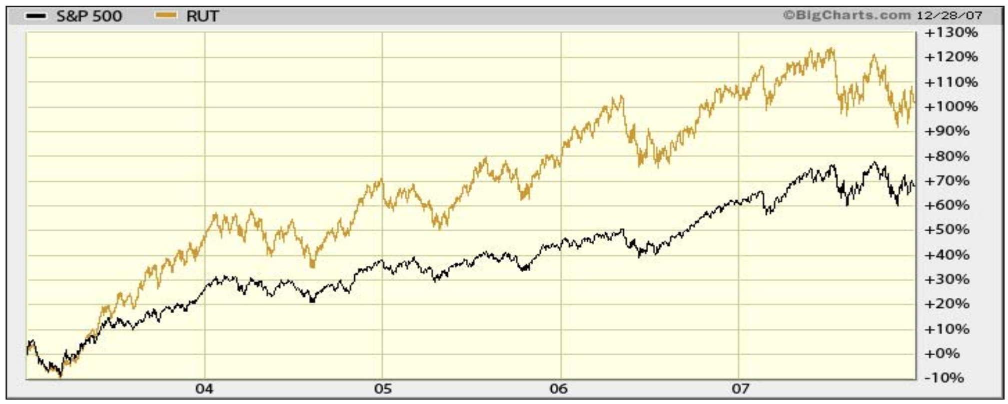

exports, bucked the trend and enjoyed a stellar year. In Asia, Japan was still mired in economic malaise but China and India posted sizeable gains as their economies showed robust growth and were unaffected by the US' problems. Led by Brazil, most Latin American markets enjoyed strong years, fueled in part by a worldwide commodity boom. For the year, the MSCI-EAFE Index was up 11.2% in dollar terms while the MSCI Emerging Markets Index was up 39.4%. Annualized returns for the trailing five years were 21.6% for MSCI-EAFE, 37.0% for MSCI-EM, and 12.8% for the S&P 500.

The decline in the dollar contributed to the strong gains in non-US stocks. In local currency terms, last year's returns for MSCI-EAFE and MSCI-EM (reported above) would have been reduced to 3.5% and 33.2%, respectively. With the credit crunch —and the lower interest rates engineered by the Fed in response to it— aggravating an ongoing trend, the dollar had one of its worst years ever in 2007, falling to its lowest level in a decade according to the Fed's trade-weighted index. The dollar fell to a record low against the Euro (having declined over 60% over the past five years vs this currency), a 26-year low against the British pound, and a level not seen in a century vs the Canadian dollar.

BOND MARKET

For the first time since 2002, Treasury securities outperformed the S&P 500. This was largely a manifestation of investors' flight to quality as most other segments of the fixed income market were negatively impacted by the subprime mortgage debacle, regardless of the actual extent, if any, that the credit of the securities in question was actually affected. While the yield on the benchmark 10-year Treasury note fell to 4.03% at year-end compared to 4.71% a year earlier (and from 4.58% at the end of the third quarter), the yield spread between corporate bonds and Treasuries widened by over 1% despite the absence of any overall deterioration in corporate balance sheets or leverage ratios. High yield "junk" bonds were particularly impacted as yield spreads over Treasuries widened over 2.5% to nearly 6% and new issuance slowed to a trickle.

Thus, while the Lehman Brothers Aggregate Index rose 7.0% for the year (3% for the fourth quarter), Treasuries gained about 9% for the year while junk bonds struggled to return about 2%.

In the short end of the market, Treasury bill rates fell as the Federal Reserve lowered the federal funds rate by 1% in three moves over the second half of the year, but the market remained weak for any securities that carried either real or perceived credit risk. Many large institutions struggled with a severely impacted market for Structured Investment Vehicles (SIVs), a form of commercial paper used to finance long-term investments, including mortgage securities.

OTHER ASSET CLASSES

2007 was one of the most painful years in memory for residential real estate but it was also the year that the market for previously strong commercial real estate also began to soften. With credit tightening, commercial property values declined for the first time in several years and the market could continue to soften as slower economic growth puts a cap on rent increases. The first rise in office vacancy rates in four years was recently announced. Going forward, however, the outlook for commercial real estate remains favorable since none of its major sectors has seen overbuilding. After a run of extraordinary returns, publicly-traded REITs suffered an inevitable correction, falling 15.7% in 2007. (Even with the loss, the market's 5-year average annualized return is 18.2%.) Fourth quarter results for the NCREIF private property index are not yet available, but this widely followed benchmark was up 12.2% through the first three quarters.

The booming private equity market was seen as one of the driving forces behind the stock market's first half strength but the market slowed considerably during the second half as higher interest rates and growing risk aversion by lenders put a crimp in deal making. Reflecting the changed market conditions, the private equity giant Blackstone Group successfully went public in June but its stock was off almost 30% by year-end. In terms of new investments made, 2007 was also one of the best years of the decade for venture capital. The industry also benefited from an improved market for Initial Public Offerings. Composite 2007 benchmark returns for private equity/venture capital are not yet available.

Hedge funds weathered a summer storm when a small number of funds (e.g., Sowood Capital, two Bear Stearns funds) collapsed as a result of ill-fated investments in subprime mortgages and a larger number of quantitatively-focused funds faced at least temporary losses when their models failed to successfully navigate the unexpected effects of the credit crunch. Nevertheless, on the whole, the volatility in the market created opportunities for impressive profits by many managers. Performance would vary by stategy and manager, but composite hedge fund returns for the year were reported in the 10-11% range, about double the S&P 500's 5.5% return. Overall, hedge fund assets continued to grow.

OUTLOOK

Looking back at 2007, the year once again demonstrated the benefits of diversified asset allocation. It is apparent that any retirement board that was predominantly invested in US stocks and bonds almost certainly did not achieve its target rate of return last year. Returns would have been enhanced by meaningful exposure to international equity and particularly to emerging markets. As noted above, hedge funds also generally outperformed US stocks and bonds last year. Boards that had investments with top tier real estate and/or alternative investments managers also had a greater chance of meeting their target rates.

Going forward, the fact that stocks are reasonably priced relative to historical price/earnings ratios is positive for the market. Yet, with corporate profit growth having declined in consecutive quarters for the first time in nearly six years, the price of oil reaching a record $100 per barrel, and the housing market still very much in distress, investors remained concerned about the economy as 2008 began. Indeed, more than half of 2007's equity gains were wiped out during the first week of the new year.

The events of 2007 proved the wisdom of former Fed Chairman Alan Greenspan's warning in 2004 that "History has not dealt kindly with the aftermath of protracted periods of low risk premiums". Indeed, some valuable lessons were learned in 2007, starting with the importance and true meaning of liquidity, which was too often confused with credit. Some of the under-appreciated dangers of some of today's financially-engineered investment products became apparent, not only in how they are rated by the rating agencies by also in how they are valued in the market. Many financial institutions were painfully reminded about the danger of going too far in relaxing conventional lending standards. Most importantly, investors of all types gained a new appreciation of the persistence of risk and the importance of assessing risk premiums before lending money or making an investment.

TOTAL RETURNS | FOURTH QUARTER, 2007

INDEX	FOURTH QUARTER 2007	TWELVE MONTHS 2007	FIVE YEARS 2003-2007 ANNUALIZED
US EQUITY MARKET			
Dow Jones Industrial Avg.	- 3.90%	+ 8.90%	+ 12.20%
Standard & Poor's 500 (Large Cap)	- 3.33%	+ 5.49%	+ 12.82%
NASDAQ Composite	- 1.80%	+ 9.80%	+15.20%
Wilshire 5000 (Broad Market)	- 3.08%	+ 5.73%	+ 14.07%
Standard & Poor's Mid-Cap 400	- 2.76%	+ 7.98%	+ 16.19%
Russell 2000 (Small Cap.)	- 4.58%	- 1.57%	+ 16.25%
GROWTH VS. VALUE			
Russell 1000 (Large Cap) Growth	- 0.77%	+ 11.81%	+ 12.10%
Russell 1000 (Large Cap) Value	- 5.80%	- 0.17%	+ 14.63%
Russell Midcap Growth	- 1.70%	+ 11.43%	+ 17.90%
Russell Midcap Value	- 5.97%	- 1.42%	+ 17.92%
Russell 2000 Growth	- 2.10%	+ 7.05%	+ 16.50%
Russell 2000 Value	- 7.28%	- 9.78%	+ 15.80%
INTERNATIONAL EQUITY			
M.S.C.I. - E.A.F.E.	- 1.75%	+ 11.17%	+ 21.59%
M.S.C.I. - Emerging Markets	+ 3.64%	+ 39.39%	+ 37.02%
FIXED INCOME			
Lehman Brothers Aggregate Index	+ 3.00%	+ 7.00%	+ 4.40%
Merrill Lynch High Yield Index	- 1.16%	+ 2.16%	+ 10.76%
REAL ESTATE			
NAREIT - Equity Real Estate Investment Trusts	- 12.67%	- 15.69%	+ 18.17%
NCREIF Property Index	+ 3.56%	+ 17.32%	+ 14.50%
	(Q3)	(Trailing 12 months)	(Estimated)